BLOG POST

Spread Compression

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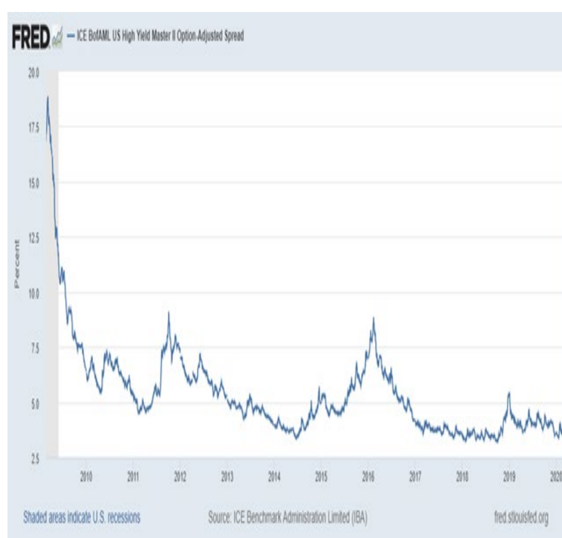
A common debate among investors and economists today concerns valuations in the high-yield bond market. With spreads, or the difference in yield, between bonds issued by companies with below investment-grade ratings and government Treasuries is fairly compressed. Historically, the yield on so-called junk bonds had to be sufficiently higher than the corresponding yield on Treasuries to entice investors. The high-yield premium had to compensate investors for the risk of default and loss of principal. But since the Great Recession of 2008-2009, the high-yield spread has come in substantially, which has raised concerns about an overvalued market.

- Based on current readings of the ICE BofA Merrill Lynch High Yield OAS Index (see chart), the current high-yield spread of 4.0% is slightly below the long-term median level of 4.8% going back to 1997, suggesting that the market might be somewhat overvalued. Given our low interest rate environment, and the overall reach for yield, there’s ample support for this argument. How much further can spreads narrow, considering that high-yield bonds returned 14% last year?

- However, the overall composition of the high yield bond market has changed since the start of the Great Recession roughly 10 year ago. Based on data from the Barclay’s High Yield Corporate Bond Index, the exposure to BB rated bonds is higher today, while exposure to CCC rated bonds is lower. Overall, the quality breakdown of the high-yield index is more favorable today.



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